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Perspectives
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PRESERVING THE STOCKHOLDER FRANCHISE: ISSUANCE OF SERIES B PREFERRED STOCK WITH SEPARATE SERIES VOTE ON ALL MATTERS SUBJECT TO STOCKHOLDER APPROVAL BREACHED DIRECTORS' DUTY OF LOYALTY AND HELD INVALID UNDER "ENHANCED SCRUTINY" STANDARD

In *Johnston v. Pedersen* (Del. Ch. Sept 23, 2011), Vice Chancellor Laster of the Delaware Court of Chancery held that the issuance of Series B Preferred Stock conferring on the holders of Series B Preferred Stock a separate series vote on any matter submitted to the stockholders for approval, including the election of directors, was invalid. Vice Chancellor Laster found that while defendant directors had acted in good faith, they also breached the duty of loyalty in granting such right to minority stockholders. Despite its somewhat perplexing conclusion, *Johnston* provides clear guidance on (1) the elevated standard directors face when making decisions involving stockholder voting rights, particularly in regards to corporate governance matters and election of directors, and (2) the conflicts that can emerge when what directors believe is best for the company is not a legitimate objective in and of itself.

Factual Background

Xurex is an early-stage company that endeavored to develop protective coatings derived from nano-technology invented by Bo Gimvang. Unfortunately, the coatings deteriorated in real-world environments and resisted several commercialization attempts. After expensive research and testing, Xurex found a limited application in the oil and gas industry, where Xurex secured one major customer, DuraSeal, which was responsible for 99% of the company's sales.

Gimvang and Bob Bishop, an early CEO, raised an additional $10 million from outside investors in a combination of common stock and Series A Preferred Stock offerings while also retaining a majority of the company's outstanding voting power. Bishop's tenure as CEO quickly drew criticism. In response to dwindling company assets and growing investor discontent, Gimvang and Bishop hired defendant Rex Powers, a recruiter who identified Bill Loven for the role of CEO.

Among other actions following his hiring as CEO, Loven investigated allegations that Gimvang and Bishop had defrauded investors, raising the ire of Gimvang and Bishop, who still controlled Xurex. As Loven pursued the matter, he soon found himself ousted by his original sponsor, Powers, who had been given proxies by Gimvang and Bishop. Powers then elected himself to the board along with defendant directors Clifford and Pedersen. Within a short time, two successive contests for control ensued. Although Powers, Clifford and Pedersen were retained on the board, they were well aware, with the addition of two other directors, that their board seats could only be maintained with the continued support of directors Gimvang and Bishop.

Powers and the other members of the board stabilized Xurex's finances with a long-term licensing deal with DuraSeal, but the company continued to face a dire need for additional capital. Although certain members of the board wanted to continue the investigation of the investor fraud allegations that Loven initiated prior to his ouster, they knew doing so could result in their own removal from the board. At this point, the board felt that Xurex could not withstand yet another proxy battle; Xurex needed "stability" (*i.e.*, entrenched incumbency) to ensure additional investment.

In an effort to address both objectives of capital and stability, the company pursued a convertible bridge loan followed by a Series B Preferred Stock financing round – with the Series B Preferred Stock having a "super voting right." As a result of the convertible bridge loan that was pushed through on an accelerated pace and the Series B Preferred Stock financing that limited investor participation and included limited disclosures and side communications, a majority of the Series B Preferred Stock ended up in the hands of board members and investors friendly towards the incumbent management. Through the "super voting right," which conferred on the holders of Series B Preferred Stock a separate series vote on any matter submitted to stockholder vote, negative control of Xurex had been sold for 12.2% of the company's post-money valuation.

DuraSeal, seeking to buy Xurex, then triggered a third proxy contest. Along with the delivery of written consents from the majority of the voting power constituted by the common and Series A Preferred Stock that replaced the board of directors, the plaintiffs also initiated an action seeking a determination that such consents (absent the consent of a majority of the Series B Preferred) were valid and effective, on the basis that the "super voting right" was invalid and conferred on the holders of Series B Preferred Stock in breach of the defendant directors' fiduciary duty of loyalty.

Court's Rulings

Vice Chancellor Laster found that the defendant directors breached their duty of loyalty by issuing Series B Preferred Stock that conferred on its holders a "super voting right," notwithstanding the accepted fact that the defendant directors had acted in good faith and subjectively believed that it was in the company's best interests that the board be entrenched before they could be replaced. However, despite their presumed good intentions, directors cannot entrench themselves on the basis that stockholders are unable to reasonably decide themselves. In reaching his conclusion, Vice Chancellor Laster applied the *enhanced scrutiny* test applicable when director actions affect the stockholder franchise and in situations "where the law provides stockholders with a right to vote and the directors take action that intrudes on the space allotted for stockholder decision-making" (quoting *Reis v. Hazelett Strip-Cashing Corp.* (Del. Ch. Jan. 21, 2011)). Under such enhanced scrutiny, the burden is on the directors to persuade the court that their actions were predicated on proper and not selfish motivations, did not preclude stockholders from exercising their right to vote or coerce them into voting in a particular way, and reasonably related to a legitimate objective. Furthermore, because the vote to issue the Series B Preferred Stock and its "super voting right" also involved the election of directors or matters that touch upon corporate control, the standard upon which the directors must support their decisions shifted from "reasonable" to "compelling," and required "a closer fit of means and end."

In applying these standards, the court found the defendant directors' justification for granting negative control to the minority holders of Series B Preferred Stock lacking and not narrowly fitted to supplying additional funding for Xurex. Defendant director Pedersen admitted at trial that the vote provision at issue was "broader than necessary to address investor concerns." Furthermore, neither the accelerated schedule of the convertible bridge loan nor the limitations placed upon investor participation squared neatly with the defendant directors' claimed legitimate purposes. Because the court did not find the board's justifications related to a legitimate purpose in a compelling manner, the court ruled that the defendant directors had breached their duty of loyalty and that the holders of the Series B Preferred Stock are not entitled to a separate series vote in connection with the election of directors. The written consent submitted by the plaintiffs and other Xurex stockholders to remove the defendant directors and replace them with directors elected by stockholders representing the majority voting power of Xurex's outstanding capital stock was upheld.

Takeaways

Johnston serves as a useful application of the following elements of the "enhanced scrutiny" standard that applies to board actions relating to stockholder rights:

- Directors must understand that good faith actions for the benefit of their company may conflict with their other fiduciary duties, such as their duty of loyalty to stockholders.

- In actions affecting a stockholder vote, the burden will be on directors to show their actions are reasonably related to a legitimate objective.

- In cases involving director elections or matters of corporate governance, a compelling justification for the action related to a legitimate objective must be shown.

Also, this case is a reminder that important fiduciary duty principles – especially the duty to respect the voting rights and the integrity of the franchise – must be considered no matter how difficult the company's financial situation.

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